



# CENTER FOR INTERNATIONAL POLICY

## CRIMINAL MONEY LAUNDERING

## AND

## ILLEGAL FLIGHT CAPITAL

**Testimony before the U.S. House of Representatives  
Committee on Banking and Financial Services**

**RAYMOND W. BAKER  
SENIOR FELLOW  
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1755 Massachusetts Avenue, NW, Washington, DC 20036

Phone: 202.232.3317 ■ Fax: 202.232.3440 ■ [cip@ciponline.org](mailto:cip@ciponline.org) ■ <http://www.ciponline.org>

## **CRIMINAL MONEY LAUNDERING**

### **AND**

## **ILLEGAL FLIGHT CAPITAL**

Thank you for the opportunity to appear before the U.S. House of Representatives Committee on Banking and Financial Services to address one of this nation's larger but least visible problems. I am Raymond Baker, a Senior Fellow at the Center for International Policy, and I have recently completed a three year assignment as a Guest Scholar at the Brookings Institution, studying the issues of money laundering and flight capital.

What I would like to do today is discuss the parallels between criminal money laundering and illegal flight capital, clarify some of the major components of illegal flight capital, discuss the benefits and costs to the United States of these flows, provide examples of how we facilitate the receipt of dirty money into U.S. accounts, briefly consider the case of Russia specifically, pose questions about the utility of offshore financial centers, recommend new fundamentals for changes in U.S. laws and regulations that will contribute to curtailing criminal money laundering and illegal flight capital, and conclude with a broader sense of the challenges facing the free market system in the 21st century.

### Parallel Flows

The theft of funds and disappearance of resources out of Russia has brought to world attention more vividly than at any earlier moment in history the problems of money laundering and capital flight. Yet, what has been taking place in and out of Russia closely resembles what has been occurring in connection with Latin America throughout the 20th century, in and out of Africa since the years of independence in the late 1950s and early 1960s, in the Middle East long riven with wealth disparities and ideological shifts and in Asia in recent decades, particularly in the last two years of the Asian financial crisis. Of equal concern must be the severe impact of these global problems on U.S. domestic and international interests.

The flow of laundered criminal money and illegal flight capital passes out of other countries and into the United States by the hundreds of billions of dollars. As destructive as these flows are, however, they are facilitated by both

U.S. public policies and private practices. The problem is not limited to a few institutions. It is one that the United States faces as a nation.

In order to distinguish money laundering from parallel financial flows that do not constitute money laundering, it is useful to add the word "criminal," to assure that what is being referred to is the movement of funds that violate U.S. anti-money-laundering legislation. This legislation specifies some 170 crimes and malpractices which establish a predicate offense for criminal money laundering.

The term "flight capital" generally does not encompass criminal proceeds but instead refers to commercial and private funds being transferred from one country to another. A distinction must be made between its legal and illegal manifestations. The legal component of flight capital is generally after-tax money that is properly documented as it passes across borders, and it remains on the books of the entity from which it is transferred. Such flows are accepted as largely beneficial to investment, trade and development, leaving aside the question of the utility of short-term capital controls.

The illegal component of flight capital is quite different. Almost always tax evading and therefore illegal out of the countries from which it comes, it is improperly documented or related to a preceding or following improperly documented transaction, and it disappears from any record in the country of its origin. The destructiveness of these flows for both transferring and receiving countries is now receiving long overdue attention.

The motivations for these two forms of flight capital differ. The legal component is normally fleeing to safety and can be expected to return to the country of origin when investment conditions are attractive. The illegal component is fleeing to secrecy, to be accumulated in a hidden manner and, as private bankers can attest, rarely returns to the country of origin.

### Components of Illegal Flight Capital

Illegal flight capital has many elements, of which the more important include the following:

- Corruption by foreign government officials, arising from misappropriation or embezzlement of public resources and bribes and kickbacks on government contracts paid into or accepted as deposits into foreign bank accounts.
- Falsification of prices on import and export transactions in order to generate a percentage or even a multiple of the value of the trade that is then paid into a foreign bank account.

- Real estate transactions and securities trades, often between related parties and improperly priced and paid for in order to shift money between countries, offer creative avenues for generating illegal flight capital.
- Wire fraud, particularly emanating from ostensibly respectable but criminally compliant banks, has become a major aspect of the problem, inundating western financial institutions with the proceeds of ill-gotten gains.

The first two of these major components of illegal flight capital -- corruption and trade mispricing -- have been carefully studied, specifically because both are dependent on international cooperation to facilitate their movement. Out of other countries into western coffers has passed at least \$1 trillion in the decade of the 1990s by these two means alone, virtually every dollar assisted by western banks and commercial firms.

The flow of corrupt money from developing and transitional economies into the United States and Europe is estimated at a minimum of \$20 billion per year and perhaps as high as \$40 billion per year. Mispriced international trade generates a flow of money from developing and transitional economies into the United States and Europe of at least \$80 billion per year. The total of these two components of illegal flight capital is therefore at least \$100 billion per year passing into western economies. It is estimated that no less than half is immediately or eventually transferred to the United States -- \$50 billion a year, a half trillion dollars in this decade.

A more exhaustive examination of illegal flight capital, including an estimate of a) the exploding wire fraud component, and b) money that flows from developing and transitional economies directly into offshore tax havens without immediate western commercial and financial assistance, although eventually lodged in U.S. and European accounts, would produce substantially higher figures, likely multiplying the total to several hundred billion dollars annually.

### Benefits and Costs

Focusing on the \$100 billion per year of illegal flight capital facilitated by the United States and Europe arising from corruption and trade mispricing, the benefits and costs of this inflow merit clear analysis. The benefit is that it brings that sum of money -- \$100 billion a year -- into western economies, at least \$50 billion to the United States. The costs can be seen in the impact of these flows on both domestic and foreign concerns.

## A) Domestic

One hundred billion dollars a year in illegal flight capital coming into the United States and Europe provides cover for a far larger amount of criminal money laundering, estimated at \$500 billion to \$1 trillion per year, again half to the United States. Illegal flight capital and criminal money laundering are two rails on the same tracks through the international financial system. The Treasury Department has estimated that 99.9 percent of the criminal money that is presented for deposit in the United States gets into secure accounts. Anti-money-laundering efforts are a failure. The United States has been progressively pursuing various aspects of this program for more than 25 years and cannot point to a reasonable measure of success. The easiest thing for criminals to do is to make their criminal money look like it is merely corrupt or tax-evading money, and when they do it passes readily into our economies.

*The domestic cost of illegal flight capital results from its removal of anti-money laundering as an effective instrument in the fight against drugs, crime and terrorism, thereby weakening our ability to prevail in facing some of the most serious threats to our society.*

## B) Foreign

Illegal flight capital facilitated by the United States and Europe has an equally severe impact on important foreign policy issues, as can be illustrated with specific examples:

- Russia, of major strategic importance to the United States and Europe, has been impoverished by the greatest diversion of resources that has ever occurred out of any country in a short period of time -- \$150 to \$200 billion in a decade by very conservative estimates, with figures as high as \$500 billion being offered. Almost every dollar of this flow has been facilitated by western business people and private and correspondent bankers.
- Nigeria is one of the principal suppliers of oil to the United States, the most populous country in Africa and pivotally important to the stability of that continent. Yet, the biggest single thief in the world in the 1990s was almost certainly the late military dictator Sani Abacha, with \$12 to \$15 billion passing out of Nigeria in corrupt and tax-evading money during his murderous five year regime, most of this to the personal accounts of Abacha and his immediate family members.

- Pakistan is a nuclear state in a volatile subcontinent, where corruption and tax evasion are so rampant and the economy so depressed that these conditions contributed to a coup d'etat, upsetting the nation's tenuous hold on democracy.
- From Mexico the flow of drugs into U.S. cities and economically depressed aliens across borders presents what many consider to be one of our principal foreign policy challenges. Yet, we legally give "white glove treatment" to high status criminals moving drug and bribery proceeds out of our southern neighbor.
- China could be the next country destabilized by corrupt and tax-evading flight capital. Semi-official estimates provided in Beijing suggest that already \$10 billion a year, probably more, in illegal funds is passing out of the country. The possibility exists that, as China integrates more into the world economy, such flows could grow to \$20, \$30 or \$50 billion a year, potentially repeating the Russian scenario.

In these and a great many other states, facilitation of the movement of corrupt and tax-evading money drains hard currency reserves, heightens inflation, reduces government revenues, worsens income gaps, cancels investment, hurts competition, limits free trade and solidifies the permanence of poverty. And it does this at a time when growth in the rest of the world is of rising importance to the economic prosperity of the United States.

*The foreign cost of illegal flight capital is manifest in its erosion of U.S. strategic objectives in transitional economies and undermining of progress and stability in developing countries comprising two-thirds of the world's population.*

For many years an implicit cost-benefit analysis has suggested that the inflow of illegal flight capital to the United States is beneficial. The time has come to question this assumption and subject it to searching reappraisal. It is highly unlikely that a case can be made showing that these types of inflows bring a net gain to America.

### Examples of Facilitation

The word "facilitate" has been used at several points above in reference to U.S. and European activities that encourage and enable the flow of illegal flight capital out of transitional and developing economies into western assets. A selection of examples of ambiguities and contradictions in policies and practices, focused primarily on the United States, will serve to illustrate the point.

- The United States has enacted cash deposit reporting requirements and anti-money-laundering legislation, beginning some 25 years ago and expanding since. In contrast, Treasury Department officials have stated on multiple occasions that it is U.S. policy to attract flight capital out of other countries, with little or no heed paid to whether or not it is tax evading.
- The United States requires a customs declaration to be filed in connection with imports and exports into and out of the United States, and it is an offense to file a false declaration. Yet, in practical terms the customs declaration is signed by a freight forwarder, not by the buyer or seller, and so long as it accords with the commercial invoice accompanying the transaction it is rarely challenged by the U.S. Customs Services. Because of this laxity, trade mispricing in the form of commissions, rebates and kickbacks is the most commonly utilized method of generating illegal flight capital, in hundreds of thousands of transactions handled by U.S. commercial firms and banking institutions.
- A perception of tax evasion is expected to generate a Suspicious Activities Report (SAR) in U.S. banks. Yet, when an exact percentage of proceeds from an international trade transaction is taken out of the domestic party's account and deposited into the foreign party's account within the walls of the same bank, even transaction after transaction, no SAR is filed, although from long experience the bankers and business people involved know full well that tax evasion is an outcome of these kickbacks.
- The United States has enacted an Advance Pricing Agreement that makes it difficult for foreign multinational corporations with local subsidiaries to misprice trade in order to take tax-evading money out of the United States, placing the onus for demanded clarifications squarely on the suspected evader. Yet, U.S. regulations are, across the board, far more accommodating to mispricing that brings corporate tax-evading money from other countries into the United States.
- The total amount of foreign aid from the United States, other Organization of Economic Cooperation and Development (OECD) countries and the World Bank combined is about \$50 billion per year. Yet, this \$50 billion inflow to developing and transitional economies is completely offset by the \$100 billion which illegally flows back out of other pockets in those same countries with U.S. and European assistance.
- No contradiction is more glaring than in connection with the issue of corruption. The Foreign Corrupt Practices Act makes it illegal for Americans to bribe foreign government officials. Yet, it is not illegal for private bankers and financial advisors to call on foreign government officials, including those perceived to be corrupt, and offer to assist them in moving, consolidating and

managing ill-gotten gains in foreign bank accounts. What U.S. law conveys, in effect, to American business people, financial advisors and bankers is, do not bribe foreign officials; however, if wealthy foreign officials are encountered, including those suspected to be corrupt, then the United States wants their money.

- Officials from Treasury, Justice and State departments, the Federal Bureau of Investigation, the Drug Enforcement Administration and the United States Agency for International Development frequently meet with foreign leaders and officials to discuss and offer assistance in addressing issues of drugs, crime, corruption and terrorism. Yet, these earnest efforts are severely undercut when commercial traders and private bankers initiate or respond to the desires of corrupt foreign officials or corporate tax evaders to move illicit funds into U.S. bank accounts.

For these reasons and more, the perception is very widespread in developing and transitional economies that the West -- the United States and Europe in the main -- is not serious about reducing the profitable part of its business which flows from the accumulation and management of the proceeds of corruption and tax evasion.

### The Russian Case

Every known method of generating and facilitating resource outflows has been utilized in the Russian situation, stripping the country of assets and liquidity with breathtaking speed. While some may regard this as a worthwhile result, assuring that communism and state ownership are unable to resurrect, it can more reasonably be argued that the bitterness engendered among Russian people is likely to take decades to dissolve.

The principal mechanism used to produce flight capital in the late 1980s and through much of the 1990s was the widespread practice of trade manipulation. For years, oil, gas, minerals, diamonds, gold and basic manufactured goods were exported, and payments were made abroad primarily in Europe, and nothing was remitted back to Russia, constituting in effect a 100 percent flight capital component on such transactions. At a point in the mid 1990s, the Russian central bank announced that exporters would be required to remit 50 percent of their proceeds within 180 days of receipt out of the country. Commercial banks were expected to monitor export transactions and inform their customers of the due dates of remittances. However, banks had no obligation to report on exporters who ignored the advice, and the practice of retaining 100 percent of export proceeds abroad continued. More recently, in 1998 the central bank required 75 percent of export proceeds to be remitted within 90 days and enacted some monitoring mechanisms. Russian exporters have reacted to this by employing the standard method of underpricing their shipments, so that the



total value does not appear on trade documents and therefore healthy kickbacks constituting the undocumented portion of the purchase price can still be paid abroad. Thus, manipulation of trade prices and commercial documentation, a commonly used procedure in other countries as well, has devastated the Russian economy, impoverished much of the population and postponed economic recovery for decades.

Could this situation have been avoided? Yes, with the device created long ago to handle such problems, the confirmed letter of credit. This would exist between a Russian bank representing the export seller and a foreign bank representing the import buyer, whereby the foreign bank guarantees to the Russian bank that full proceeds will be remitted within days of passage of title for the goods shipped. Coupled with even the most casual price verification of export documents and marginal scrutiny of transactions of exporters selling to their own importing subsidiaries abroad, hundreds of billions of dollars which have escaped from Russia could have been very substantially curtailed.

Who should have put in place a requirement for letter of credit terms on export shipments? Certainly the Central Bank of the Russian Federation. But in the absence of the necessary political will, then the International Monetary Fund and the World Bank had both the opportunity to insist on use of standard trade practices and an obligation to do so. The West should be encouraging adoption of the norms of the free market system instead of cultivating the aberrations of the free market system. Failing to do so, accountability must be apportioned.

### Offshore Financial Centers

The greater part of dirty money, out of Russia as well as out of other transitional and developing economies, is generated transactionally. Such transactions, more often than not, produce balances in the first instance in western banks. These balances are then frequently spirited out of western deposits, perhaps through labyrinth channels, and put into obscure havens. Secrecy havens are not usually involved in original transactions but instead offer a temporary or long-term resting place for purloined proceeds, accumulated and maintained beyond the scope of adequate regulatory review.

The question to ask is, why should the United States accept correspondent banking relationships and overnight deposits from such havens, whether offshore financial centers or bank secrecy jurisdictions? Two answers are offered. First, it is argued that, "If we don't take the money, someone else will." Second, the case is made that a portion of the correspondent relationships and deposits out of offshore financial centers is legitimate, and we lack the means of distinguishing illegal from legal funds from all such jurisdictions. Resolution of this issue centers on the cost-benefit analysis earlier called for. If

a persuasive analysis cannot be formulated showing that these flows, illegal combined with legal, strengthen our society and economy and foreign priorities, then a reversal of U.S. policy recommends itself.

The position of the United States should be that we will accept no money from offshore financial centers and bank secrecy jurisdictions unless their regulatory mechanisms meet U.S. anti-money-laundering approval. Implementing such a policy should proceed in three phases. First, so called "brass plate" banks operating out of foreign jurisdictions, doing no local business and unregulated by competent authorities, should lose their correspondent account privileges immediately. Second, upon publication of a list of non-cooperative financial jurisdictions by the Financial Action Task Force (FATF), anticipated in June 2000, each jurisdiction named should be given a time frame, e.g., 12 to 18 months, to establish and place in effective operation anti-money-laundering procedures which meet U.S. approval, or, in the absence of such, U.S. correspondent banking privileges will be forfeited. Third, upon publication of a list of jurisdictions classified as tax havens by the OECD, also anticipated shortly, each jurisdiction so named should likewise be given a specific time period to meet U.S. satisfaction in anti-money-laundering efforts or lose U.S. correspondent banking privileges.

The message emanating from the United States to offshore financial centers and bank secrecy havens would be straightforward -- you cannot do banking business with the United States unless your anti-money-laundering standards meet U.S. approval. For U.S. corporations that maintain accounts in offshore financial centers, the message would be equally clear -- you can do business only in those centers which have passed U.S. muster. For other G-7, OECD and FATF partner countries around the world, the message would be unambiguous -- we no longer want our "fair share," an expression used by a U.S. official, of ill-gotten gains and are prepared to forego such receipts while working to reduce the problem of dirty money on a global scale.

### Fundamental Redirection

As we distance ourselves from those who harbor ill-gotten gains, we must cease to harvest ill-gotten gains. While there are no simple solutions to the vast range of complexities in this problem, there are fundamentals that should be incorporated into freshly structured approaches.

The first fundamental is a decision that we, as a society, do not want dirty money in our financial system. That decision has not been taken, as evidenced by the many ways in which we facilitate movement of such money into U.S. accounts and the many contradictions in U.S. law that permit and encourage such inward transfers. Even though all the mechanisms are not in place to

prevent the inflow of illicit proceeds, harm is caused when we are ambiguous as to our underlying intent, confirming to people around the world that America welcomes their money virtually regardless of derivation.

The second fundamental is bringing the U.S. position clearly to the attention of the rest of the world. This should include two quite straightforward steps: A) U.S. financial institutions should inform all foreign account holders that it is against U.S. policy to receive criminal, corrupt or commercially tax-evading money into U.S. accounts. B) Foreign account holders should be asked to sign periodically an acknowledgment that they have been so informed, that their account activity constitutes money that has been legally earned and legally transferred and that they are aware of penalties for making a false declaration. Such a statement required of foreign account holders will have little or no effect on the legitimate activities of firms that are abiding by the laws of countries where they do business. It will, however, have substantial effect on those who have been transferring corruptly derived or commercially tax-evading flight capital to our shores, encouraging them to cease such activities when dealing with U.S. financial institutions or take such proceeds to other depositories.

The third fundamental is consistent application of regulatory requirements. The records of every foreign account, whether within banks, securities dealers or other types of financial institutions, should contain a signed report by an officer attesting to inquiries and examinations confirming that deposits and inward transfers to these accounts (possibly above a threshold amount such as \$10,000) have been scrutinized, including through third parties, to reasonably assure that such inflows comprise money that has been legally earned and legally transferred. Large accounts and the accounts of all foreign government officials should require two such reports. The situations involving Citibank that recently were highlighted in hearings before the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs of the U.S. Senate, revealing severe lapses in anti-money-laundering efforts involving account holders in Mexico, Nigeria, Gabon and Pakistan, would have been prevented by such procedures and should not now be allowed to recur. Consistency in application of clearly laid out oversight requirements placed upon foreign accounts will have a major impact on reducing abuses of U.S. banking and financial privileges.

The fourth fundamental that should guide redirection of U.S. policy on this issue is flexibility, allowing for temporary exceptions to standard policies. Friends of the United States who face violence, kidnap, threats or political harassment should be able to make emergency transfers from which personal drawings are allowed, while review of the circumstances of the exceptional arrangement progresses over a period of months. Provision for immediate handling of transfers in such cases will bolster cooperation with the broader regime of U.S. anti-money-laundering efforts.

These four fundamentals -- A) rejection of dirty money as a matter of policy, B) periodic reconfirmation of this policy given to and received from foreign account holders, C) consistency of regulatory requirements and oversight, and D) exceptions made available in situations of potential violence or harassment -- incorporated into U.S. financial practice will very significantly curtail the flow of ill-gotten gains into our economic system, discouraging lodgment in the United States of the proceeds of foreign corruption and commercial tax evasion. After establishing these fundamentals in the U.S. banking and financial system, efforts should then be made, as was done in the case of the Foreign Corrupt Practices Act, to encourage adoption of similar provisions by other governments.

### The Free Market System in a Globalizing World

We have to be careful about what we get used to. We have grown to accept that our pursuit of corrupt and tax-evading money out of other countries is routine and normal. The argument is offered that it is not our responsibility to enforce the laws, particularly the tax laws, of other countries. While true, this misses the point. The question is, is it in our interest to help foreign citizens break the laws, again focusing on the corruption and tax laws, of their countries? By avoiding the difficult questions, we have allowed ourselves to become, by all credible estimates, the world's largest repository for ill-gotten gains. In so doing and in continuing to do so, we damage our domestic society, devalue the lives of billions around the world and derail some of our most vital foreign policy efforts.

The combination of criminal money laundering and illegal flight capital constitutes the biggest loophole in the free market system. Drug kingpins and global thugs thrive because money laundering is easy, and money laundering is easy because illegal flight capital is cultivated and maintained. No western nation is more harmed in this process than the United States. The fallacy in our policy is that we attempt to control the criminal element of illicit flows while pursuing and facilitating the illegal flight capital element of these flows. This is not possible. We will never effectively curtail the one while at the same time soliciting the other. Success in fighting dirty money can only be achieved when we address all three parts of the problem -- criminal, corrupt and commercial.

Attachment:

Raymond W. Baker, "The Biggest Loophole in the Free-Market System," *The Washington Quarterly*, Vol. 22, No. 4 (Fall, 1999), pp. 29-46.

## The Biggest Loophole in the Free-Market System

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Soon after arriving in Nigeria in 1961, I got into a conversation about how to do business in Africa with the director of John Holt Trading Company, a British-owned firm that had been around since the 1800s. When I asked how he priced his imported cars, building materials, and consumer goods, he said it was not his intention to produce a profit but rather to generate high turnover. Having spent two years at Harvard Business School reading balance sheets and income statements, I had no idea why anyone would run a business with disdain for the bottom line.

By the end of the decade, I was, perhaps, marginally wiser—after setting up two companies, buying two others, witnessing a lot of skullduggery, and surviving the Nigerian civil war. A third acquisition opportunity presented itself, a medium-sized packaging manufacturer whose pesky balance sheets and income statements showed five years of losses. I figured the Syrian family that owned majority interest, besides being poor managers, was doing the same thing John Holt was doing—overloading import prices and thereby undercutting local profits in order to generate hefty kickbacks out of the country. I offered ten times book value to buy the company, which Harvard students later studying the case unanimously agreed was evidence of tropically induced dementia. After the acquisition, I purchased imported raw materials at much cheaper world-market prices, paid off all the debts in the first year, and then distributed generous dividends to myself and minority stockholders for years thereafter. These and a great many other experiences and observations in the 1960s and 1970s initiated my awareness of certain aspects of financial chicanery, in particular, how to make money disappear

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Raymond W. Baker, with a career in international business concentrated primarily in developing countries, is a guest scholar in Economic Studies at the Brookings Institution. The views expressed in this piece are those of the author and should not be ascribed to the trustees, officers, or other staff members of the Brookings Institution.

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in one place and reappear in another.

Over time it has become clear that I was seeing only the tip of a global iceberg. In 1980s trading activities, I observed the means of moving money illegally by others in some 20 countries, and in the early 1990s I carefully undertook highly structured, in-depth investigative work on this subject with more than 500 business owners and managers in a dozen countries. In 1997 I talked at length with some 335 central bankers, commercial bankers, government officials, economists, lawyers, and sociologists in 23 coun-

tries about this phenomenon.<sup>1</sup> What I have learned is surprising if not startling.

**The bottom line is that anti-money-laundering efforts are not working.**

Dirty money is an opaque subject, fraught with murky uncertainties, shunned by international financial institutions and inadequately addressed by government officials. Estimates of its magnitude, either made by others or developed in the course of work leading to this article, suggest that roughly \$500 billion to \$1 trillion of international

criminal proceeds and another unknown sum in the hundreds of billions of illegal flight capital<sup>2</sup> is sent across borders and deposited into private bank accounts annually. In the short term, perhaps half of this money comes to the United States and half goes to Europe, while some of the deposits in Europe eventually wind up in dollar-denominated holdings. Criminal money has now likely accumulated to several trillion dollars in hard currency assets, and tax-evading flight capital to perhaps a comparable amount. Western countries fight crime with one hand and welcome dirty money with the other hand, in contradictory practices long on tradition and short on thoughtful analysis. Disingenuous hand-wringing substitutes for action on both sides of the Atlantic. Addressing the dirty-money problem suffers from a lack of will, not a lack of solutions.

The two components of dirty money differ in origin and hence in the degree of their illegality. First, money that has a serious criminal antecedent, defined by many countries as drug trading and by the United States and some other countries as also including counterfeiting, espionage, gun running, extortion, kidnapping, toxic waste, nuclear materials, slave trading, alien smuggling, and more is referred to as "laundered" as it passes through financial systems. Furthermore, it is illegal to knowingly receive such money in the United States and other countries that have adopted anti-money-laundering legislation.

Second, money that arises from corruption, tax evasion, and currency smuggling is referred to as "illegal flight capital" as it exits the home coun-

try. The generation of this money is illegal in countries from which it comes; however, it is almost always legal to receive such money elsewhere, including in the United States, Europe, the Middle East, Asia, and a host of tax havens around the world.

## Money Laundering

I was recently told in Frankfurt that 99.99 percent of the criminal money that is presented for laundering in Germany is believed to pass successfully through the banking system's regulatory roadblocks and into secure deposits. In Zürich, an estimate from the Swiss central bank was the same. In Washington, Treasury Department officials left off the second decimal and said that 99.9 percent of laundered money is safely deposited into U.S. banks. The bottom line is that anti-money-laundering efforts are not working. Officials know it but claim they cannot figure out why.

The U.S. Bank Secrecy Act<sup>3</sup> has since 1972 required financial institutions to report to the Treasury Department cash deposits of a certain magnitude—now \$10,000 or more—or any pattern of suspicious transactions. This requirement has led banks to set up costly compliance offices and to adopt “due diligence” procedures, placing responsibilities on bank managers to “know your customer,” so that large and repetitive cash deposits or unusual transfers can be spotted. Under U.S. prodding, most European and some other countries have set up similar procedures, although only 10 nations can be said to exercise marginally active oversight.<sup>4</sup>

Despite the fact that for more than 25 years money laundering has not been curtailed to any perceptible degree, law enforcement officials proudly point out that the cost of laundering has risen. Criminals paid only 5 percent or 6 percent in commissions some years ago, whereas it now costs around 20 percent.<sup>5</sup> Criminals laundering money still circumvent the roadblocks; it just takes more time and ingenuity.

For a small, local drug distributor in the United States or Europe with a take of a few million dollars a year, the simplest way to launder cash without detection is “smurfing”—using a few innocuous-looking bag men to deposit random amounts of less than \$10,000 into variously named accounts at many different banks. Due diligence rarely catches this activity.

Drug kingpins, however, with hundreds of millions of dollars in cash in assorted denominations, weighing several tons and occupying a volume larger than the drugs themselves, have a more onerous laundering task. Smurfing will not work because it would require hundreds of innocuous-looking bag men making repeated trips to the banks, not to mention the control problems arising from those bag men foolish enough to try to ab-

second with their day's deposit. Using cash to live high and buy cars and houses is not very smart and fails to soak up much of the hundreds of millions. So basically the kingpins are left with two choices, both of which move the transaction into the international arena—ship cash or ship goods overseas.

"Mules" carry briefcases or suitcases with hundreds of thousands of dollars of cash for deposit into Caribbean banks, though this is risky. More commonly, bundles of dollars are concealed in refrigerators, overstuffed furniture, machinery, industrial products, coffins, or even dead bodies for shipment to Mexico, Panama, Colombia, Nigeria, Pakistan, or almost any other country with lax regulations where large dollar deposits into branch banks are enthusiastically welcomed.

Alternatively, the cash can be spent to buy something else that can cross borders. Retail businesses or chains that already deal in large amounts of cash are a natural supply source. For example, a transaction can be made for shipment of \$5 million worth of appliances or electronics, for which the kingpin will pay \$6 million, thus giving the seller 20 percent for laundering services. The seller feeds this \$6 million into his normal cash receipts and deposits. The kingpin takes delivery of the goods in another country, sells them and deposits the \$5 million or so in bank accounts. Then without much difficulty this money can be transferred back to the United States or Europe.

There are huge numbers of variations on these themes of moving cash or goods or for that matter services or securities across national borders. But what is most striking is that those doing the laundering have not invented any new ways of transferring money from one place to another. They have merely stepped into the same channels that have been developed and used for years and years by businessmen and bankers—the processes of moving illegal flight capital.

### **How to Get Rich and Hide Money**

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Flight capital has both a legal and an illegal component. The legal component arises when someone decides to diversify assets into another country and does so properly by using after-tax money, complying with necessary documentary regulations, and retaining the asset on the books of the entity from which it is transferred. Most, though certainly not all, of the money that recently fled from Asia constituted legal, surplus funds seeking safety from exchange risks. While sudden transfers introduce volatility into global capital movements, the absence of controls spurs foreign investment in open markets and has been demonstrated to be generally beneficial to nations focusing on growth.



Illegal flight capital is another matter entirely, as can be seen by understanding how it works. The most widely used but least glamorous means of generating illegal flight capital is the falsification of foreign trade prices, usually overpricing imports and underpricing exports. This practice is done secretly and almost never put in writing. For example, a business manager or owner in Venezuela negotiates to purchase machinery from a U.S. manufacturer. He requests that the \$1 million price be increased by 10 percent so that upon payment of \$1.1 million for the machinery the extra \$100,000 is to be deposited into his private bank account in the United States. This overpricing is illegal under Venezuelan law; it evades taxes, and the money paid disappears from the assets of the company and the country.

Similarly, an exporter of art works in Ukraine can sell her paintings, sculptures, and icons to a West European dealer for, say, 50 percent less than their negotiated value, with the understanding that when payment is made the extra 50 percent will be deposited into her German bank account. Again, illegal; the funds evaded taxes and disappeared from any record in Ukraine.

**Money laundering is easy because illegal flight capital is pursued and facilitated.**

The second most common means of generating illegal flight capital is corruption—stealing—by government officials. Mobutu Sese Seko of Zaire, now Congo, and Ferdinand Marcos of the Philippines were world renowned for their thievery, both reportedly able to have money transferred directly from central bank reserves to their overseas personal accounts. Other leaders with less power, such as Stroessner of Paraguay, Craxi of Italy, and Houphouët-Boigny of Ivory Coast, were more likely to use middlemen to arrange government contracts or licenses or concessions in return for payments of huge bribes, always into foreign bank accounts. And such corruption is not limited to heads of state. There is ample record of ministers, civil servants, directors of government-owned utilities, airlines, and other corporations, as well as ambassadors and generals, playing the flight-capital game through kickbacks paid abroad on everything from armored personnel carriers to the embassy catering bill.

A third form of illegal flight capital involves black-market currency deals and petty smuggling. An expectant traveler goes into a back alley, converts pesos to dollars, and hopes to avoid a search when passing through customs.

There are many other ways the same end is accomplished, including paying for imports and exports that do not exist or for services never rendered, cross trading through cooperative brokers who eventually lose one leg of the

deal, transferring business and property ownerships offshore without repatriating full compensation, and carefully constructing bank transfers of untaxed funds. And while all of these additional methods are important, it is extremely difficult to estimate their magnitude.

Many observers think that illegal capital flight is a temporary reaction to unstable conditions in countries from which it comes, that is, short-term money parked outside to avoid threat of confiscation or to evade taxes or, like its legal counterpart, to minimize inflation and exchange risks. The argument accompanying this idea is that once a country confidently achieves stability, the incentive for illegal flight capital will disappear. Similarly, these observers say that money arising from government corruption will decline with democracy, accountability, and the rule of law. While all of this has an element of truth, it demonstrates a misunderstanding of the most basic reason for these illegal flows and the role of western businesses and financial institutions in serving this demand.

The primary motivation for illegal flight capital is the hidden accumulation of wealth. It is about getting rich secretly and avoiding pressures to distribute profits locally. For that Venezuelan businessman who had \$100,000 deposited into his foreign bank account, not another person in Venezuela needed to be aware of that transaction. The same is true for the government official who has a bribe paid into his foreign account. Concealed payments made on verbal agreements allow both of these individuals to gain, while avoiding demands from relatives and in-laws or from employees and managers or from other government officials to share the riches. The secret amassing of wealth is what keeps this business going long after a country has put its affairs in order.

Besides the push by foreign commercial elites and government officials for flight capital abroad, there is a pull exerted by Western companies and financial institutions. Americans, Europeans, Japanese, and others legally pay kickbacks on transactions with foreign private interests. This is routine in winning and maintaining export and import orders in soft currency markets, and, while the practice abets breaking tax and other laws in those countries, it rarely breaks laws in the industrialized countries.

Bankers from these same Western countries approach foreigners to make arrangements for the movement of flight capital, advising how other customers have done it, providing introductions to overseas traders, offering to assist with necessary credits and documentation and ultimately managing the accumulating funds in their private banking departments. While I was in New Delhi recently, a Swiss banker was calling on potential customers offering to set up private accounts in her bank, even though it is against the law for Indians to have such accounts out of the country.

The U.S. Foreign Corrupt Practices Act<sup>6</sup> makes it illegal to pay bribes to foreign government officials but says nothing about bribes to foreign private citizens. An American machinery salesman taking two managing directors to lunch in Southeast Asia, both heads of vegetable oil mills, one government-owned and the other a private enterprise, risks a jail term for bribing the director of the government mill and gets a pat on the back from his boss for bribing the director of the private firm. And, of course, the American's competitors from most other countries can bribe both managing directors with impunity, although we have finally persuaded the Europeans to consider enacting legislation similar to our own, with prohibitions against bribing government employees and officials.

Meanwhile, the best informed legal experts in the United States and abroad confide that what appears to be a majority of U.S. Fortune 500 companies circumvent the FCPA by a multitude of means, including agents' commissions, parallel transactions, countertrade deals, and charitable trusts, among others. Arms manufacturers are particularly pliable. A prominent expatriate lawyer in the Middle East explained the way he does it as follows: Weapons sales generally involve requirements for support services such as training, maintenance, and software updates. Defense and military officials in the purchasing country typically request that these ancillary services be provided through a joint venture company between the arms manufacturer and local participants. Entities for this purpose are incorporated offshore, often in a tax haven such as the British Virgin Islands, with joint venture partners who are relatives or friends of the officials. While doing no work, these partners share in the venture's bloated revenues, passing the funds along to their principals. As long as the U.S. firm had no "intent" to bribe, these arrangements are overlooked by regulators anxious to maintain the flow of U.S. weapons and influence.

The desire of foreign private citizens and government officials to accumulate hidden wealth is accommodated attentively and creatively by Western businesses and banks. And by accommodating this activity—this movement of flight capital that passes illegally out of one country but almost always legally into another country—they are providing exactly the same channels through which criminal money is laundered.

### **Money, Money, Money**

One of the difficulties in dealing with this subject is arriving at believable estimates of the magnitude of illegal flows. A 1997 United Nations report estimates the international drug trade alone at \$400 billion a year<sup>7</sup>—8 percent of world commerce. The Financial Action Task Force in Paris, an anti-

money-laundering coordination group, has been attempting to consolidate money laundering estimates from its members, with \$500 billion annually being a commonly mentioned figure.

Measuring flight capital is complicated by the intermingling of its legal and illegal components. International trade and financial statistics make no effort to distinguish between the two, and therefore the illegal portion remains almost completely invisible in such data. For example, on that transaction by the machinery manufacturer with the Venezuelan customer, as far as U.S. export and Venezuelan import statistics are concerned, that machine was worth \$1,100,000. Using every available piece of official data, there is no way to demonstrate that money was diverted into a private account.

The aspects of illegal flight capital which lend themselves to rough estimation are those which involve cooperation between parties in Western nations and counterparts in developing and transitional economies. Other aspects of the phenomenon, where money goes out of a country directly into a tax haven, are virtually impossible to fathom.

I have developed techniques for measuring illegal flight capital that occurs through price manipulation. For example, a selection can be made of several hundred documents covering imports into and exports out of a foreign country. Prices on these transactions can be checked by negotiating fresh quotations on the same items under the same terms with the same suppliers, but with different destinations to disguise the inquiry. This process, and others, can reveal a pattern of mispricing, and such a pattern can be tested by additional investigative methods that focus specifically on kickbacks paid abroad.<sup>8</sup>

Based on such work, the proportion of foreign trade transactions that are falsely priced going into or out of Latin America is indicated to be between 45 and 50 percent, with Argentina, Brazil and Venezuela all falling within or close to this range. Mispricing levels average more than 10 percent. Multiplying these two percentages produces an estimated flight capital component for Latin American trade of 5 percent, amounting to \$25 billion to \$30 billion annually.

For Africa, 60 percent of trade transactions are indicated to be mispriced, by an average of more than 11 percent, resulting in a flight capital component of 7 percent on African trade, totaling \$10 billion to \$15 billion annually. Ivory Coast and Nigeria exceed the 7 percent norm considerably.

One of Russia's unsolved problems is that payments for many export shipments of oil, gas, minerals, diamonds, gold, and basic manufactured goods are made in foreign currencies, which are deposited abroad and never converted into rubles despite prevailing regulations, creating effectively a 100 percent flight capital component, totaling \$15 billion to \$25 billion per year.

Other Commonwealth of Independent States (CIS) countries, in particular Ukraine, Belarus, Uzbekistan, and Kazakstan, are notoriously porous, adding \$5 billion to \$10 billion or more to flight capital flows.

Measuring price manipulation into and out of the Middle East is complicated by the fact that the recycling of petrodollars makes it unclear what is and is not legal. Nevertheless, omitting oil exports from kingdoms and sultanates, the remainder of Middle East trade produces flight capital on the order of \$5 billion to \$10 billion annually. Indonesia, Pakistan, India, Thailand, and Burma alone generate another \$5 billion to \$10 billion. A similar estimate could be made for East Asian countries, including principally Hong Kong, South Korea and the Philippines, before the 1998 currency crisis accelerated the drainage. And semi-official figures given to me in Beijing indicate that mainland China's illegal outflows are at least \$10 billion a year and probably more.

**Addressing the dirty money problem suffers from a lack of will, not a lack of solutions.**

As to theft by corrupt government officials that results in flight capital, the biggest offenders in recent years certainly include Russia, Iraq, Nigeria, Congo, Venezuela, Pakistan, Algeria, Egypt, Indonesia, Burma, the Philippines, South Korea, Mexico, Paraguay, Peru, Panama, Haiti, Ivory Coast, Kenya, Italy, and lately the People's Republic of China. In many other countries, ambitions may be large, but treasuries are rather small.

If a country keeps modestly accurate trade and financial data, those sectors of the economy which are controlled by the government can be revealing. For example, at the request of a successor government, a Nigerian economist recently examined oil income received by the preceding government. He found that during the Persian Gulf crisis, when petroleum prices shot up, \$12.2 billion of Nigeria's receipts escaped adequate accounting. Saddam Hussein of Iraq has similarly tapped oil revenues in the past to secrete billions overseas.

For leaders and officials without dictatorial powers, transfers expropriated and bribes paid abroad can be estimated only in the short term. Some credence must be given to reports by other government officials, traders, bankers, Western ambassadors, and embassy economic officers who may have a good idea of the prevailing level of corruption and the amount of that corruption that ends up overseas.

Reasonably well-informed estimates of flight capital through this kind of official corruption put the figure at a minimum of \$20 billion per year and

possibly as high as \$40 billion per year. While many second-echelon officials get away with their ill-gotten gains, the success rate for heads of state is hardly encouraging. Mobutu was usually holed up in his hometown palace or one of his foreign villas. Marcos was driven out. Craxi of Italy is on trial in absentia. Noriega is hardly enjoying the Florida sun. "Baby Doc" Duvalier, Haitian in exile, is broke. Carlos Salinas was certainly uncomfortable when he briefly returned to Mexico. Daniel arup Moi of Kenya is under pressure. Samuel Doe, the deposed head of Liberia, was tortured and mutilated while being asked for his Swiss bank account numbers, as I saw in a gruesome video which was made shortly before his execution.

The total flow of these components of illegal flight capital is in this analysis about \$100 billion to \$150 billion per year, and an average of \$100 billion annually is probably a very conservative figure. Other components that do not usually depend on Western involvement may be larger.

### **The Importance of the Issue**

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The consequences of Western solicitation and acceptance of illegal flight capital and the correlative flow of laundered criminal money are huge. For the United States the documentation is well reported—drugs in society, gang warfare, drive-by shootings, an expanding prison population, racial tensions, inner-city decay, threats to a generation of urban youth, and parents deeply concerned about the potential impact of crime and drugs on children. What has not been well reported is that money laundering, the key to this activity, is almost universally successful.

Besides drug dealers, other international criminal organizations, including terrorists—Osama bin Laden, for example—likewise benefit from having clandestine channels readily available for moving hot money around the globe. Trade in nuclear, chemical, and biological weapons components has reached alarming proportions, certainly in the hundreds of millions of dollars if not considerably more. When Saddam Hussein and Muammar Qadhafi purchase machinery and materials for this purpose, they set up elaborate dummy corporations and circuitous money laundering procedures to cover their transactions, easy to do in the Middle East where billions in illegal money pass to Europe regularly.

Money laundering's fellow traveler, illegal flight capital, badly undermines U.S. and European foreign policies. The total of all U.S. foreign aid and the bilateral assistance of all other countries of the Organization for Economic Cooperation and Development (OECD), as well as all World Bank financing going into developing countries and former Communist states amounts to about \$50 billion a year. This is completely offset by the

\$100 billion a year that comes back out of recipient countries with Western complicity into private bank accounts abroad. Flight capital drains hard currency reserves from poorer states and transitional economies and, in the process, heightens inflation, reduces tax collection, worsens income gaps, cancels investment, hurts competition, undermines free trade, and solidifies the permanence of poverty. A Western focus only on the dispersing side of the development equation—foreign aid, World Bank financing, International Monetary Fund (IMF) credits, and so forth—while ignoring the illegal return cash flows of greater magnitude, is woefully inadequate to the challenges of poverty, development and globalization.

**Illegal flight capital badly undermines U.S. and European foreign policies.**

The consequences in major regions of the world are severe. Russia has suffered the greatest theft of resources that has ever occurred from any country in a short period of time—\$150 billion to \$200 billion in a decade. This is the low end of figures (which go as high as \$350 billion) compiled by premier economists in the country and is an amount substantially more than the \$120 billion<sup>9</sup> in economic assistance given to Russia by Western governments, the World Bank, and the IMF combined. Foreign bankers have marketed aggressively in Moscow and other cities, and European vaults are bulging with Russian flight capital. Cyprus has been a popular ex-Communist money laundromat, now supplemented by Malta, Gibraltar, and Lebanon, with major transfers going to deposit accounts and real-estate purchases in Switzerland, Germany, France, England, Spain, Turkey, and especially Israel.

In the volatile Middle East the gap between individuals with hundreds of millions, even billions, spirited out of the region and others tied to mud and stone villages is explosive. Islamic fundamentalism is preached principally in the mosques of the poorer strata of society. The numbers living in poverty in Egypt have soared in recent years, while government officials bragged to me about forcing one corrupt executive in a state-owned firm to repatriate \$50 million from Switzerland to Cairo.

In Saudi Arabia, corruption and flight capital are neither illegal nor tax evading. Kickbacks to government officials are acceptable so long as the level is not offensive to the king, and there are no income taxes of significance to evade. Thus, \$400 billion of private Saudi money is in foreign accounts, and resentment is rising over the excesses of the royal family.

Latin America has been exporting illegal flight capital throughout the twentieth century. Currently, Swiss bankers report that they see no diminu-

tion but rather continued increases in flows out of Latin America into private accounts.<sup>10</sup> In the 1970s and '80s most Latin American governments were collecting only a fraction of lawful taxes and were experiencing heavy illegal capital flight through the overpricing of imports. So they installed value-added taxes of about 20 percent on imports and legalized outward capital transfers to try to remove the incentive for illegal transactions. Many sectors of the business community immediately reversed their *modus operandi*. As an example, in Argentina they now substantially underprice their imports to escape value-added taxes (VAT) and operate part of their businesses completely off the books to generate side revenues. They then take these unrecorded revenues to the bank to make a legal capital transfer abroad, which is in fact a trade payment for the balance due, plus the traditional extra component, on their underpriced imports. Thus, for Latin American governments, tax collection is not much improved and flight capital is not much diminished, because the primary motivation for this illegal activity still remains—the concealment of accumulating wealth. And, furthermore, because of this practice, Latin American trade and capital statistics are intermixed or mislabeled to the tune of 5 percent or more yearly, making it impossible to know accurately the status of these “emerging markets.”

Finally, Africa, the world's most despoiled continent, has had a greater portion of its resources stolen than any other part of the world. There are thousands of businesses in Africa which operate at the break-even point or marginally in the black or even in the red with local currency replenishment in order to provide continuous flight capital out of the continent. Ever since African countries became independent, dictators, corrupt government officials, and wealthy businessmen have been called on by bankers from the United States, England, France, Germany, and Switzerland seeking their money. In the time it takes to read this article, illegal flight capital out of the continent equal to the annual incomes of at least ten thousand Africans is being deposited into Western accounts. And this does not include the greatest example of price manipulation known to have occurred and continuing to this day, according to a prominent central banker: a century of diamond exports out of his country at essentially zero value, to be graded, cut, and sold abroad, with only a small portion of profits brought back to keep mining operations going. The World Bank estimates that nearly 40 percent of Africa's accumulated wealth, which might be contributing to basic necessities of life, is instead in foreign accounts, strengthening Europe and the United States.

A half-century ago it was said that Western countries should assist by whatever means necessary movements of money for Holocaust victims,



families escaping Eastern Europe, Arabs fleeing domestic turmoil, Chinese businessmen departing the mainland, and more. In the chaos of earlier times, that was no doubt true. But today, the \$100 billion yearly flow in illegal flight capital which the West facilitates fails to serve any legitimate purpose the United States and Europe have. Western economies are not dependent on this inflow, and Western governments and financial institutions should not be targeting the foreign exchange assets of weaker trading partners, eroding the tax bases of friendly countries around the world. Furthermore, and perhaps most important to Americans and Europeans, this \$100 billion of illegal flight capital provides cover for \$500 billion or more of criminal money laundering. These are two rails on the same tracks through the international financial system. Trying to restrain movement on the money laundering rail while going full speed ahead on the flight capital rail is not possible. When we determine to curtail illegal flight capital, the problem of criminal money laundering will substantially decline.

### **The Maginot Line**

Several arguments have been offered in defense of the status quo. First, it is suggested that any attempt to correct the illegal flight capital situation would restrict free trade. The truth is just the opposite. When a buyer and seller get comfortable in an arrangement that generates flight capital in a convenient, secret manner, it is almost impossible to break that arrangement. A friend of mine recently called on the managing director of a potential corporate customer in Africa to offer linerboard (paper to manufacture corrugated cartons). His sales terms were identical, and his prices were significantly lower than the user was paying. After the meeting, a second person, the purchasing manager, walked with him out of the factory and said, "Forget it; the current supplier handles the M.D.'s commissions in Europe." I have observed this situation repeated hundreds of times. Removing the flight capital component would open trade and stimulate competition.

Second, it has been argued that any country acting against false invoicing will lose the commerce that is tied to this practice, as trading partners in other countries take their business elsewhere. This is the same argument that was offered in opposition to the U.S. Foreign Corrupt Practices Act. In fact, in relative terms, little harm accrued to U.S. trade resulting from this act, and Europeans are now moving toward adoption of anti-corruption positions similar to those enacted by the United States two decades ago. As with the corruption issue, U.S. leadership on the illegal flight capital problem would be highly beneficial.

Third, it has been pointed out that transfer pricing between parent and

subsidiary can be a form of flight capital. For example, pharmaceutical and chemical companies often charge their foreign affiliates as much as five or ten times home-country prices for proprietary items exported to them. While these situations work for a while, government scrutiny, customs inspections, external price verification services, and normal competitive forces usually restrain such activities over time.

The toughest laws against illegal flight capital via exaggerated transfer pricing exist in, of all places, the United States. Throughout the 1970s and '80s, the Internal Revenue Service (IRS) was frustrated with many foreign subsidiaries operating locally, particularly Japanese ones, because they reported minuscule profits and therefore paid little or nothing in U.S. taxes. Often, such firms were overpricing their exports of component parts and finished goods to the United States, so that margins were transferred back to the parent company within the selling prices of the items and not accumulated on their American subsidiaries' books as profits. Under regulations that were strengthened in the 1990s, the IRS can now levy taxes on reasonably estimated U.S. profits that would have been earned had not transfer prices been excessive, and if the subsidiary chooses to dispute the assessment, the parent company must provide access to corporate pricing data. Thus, while the United States reacts with resolve on pricing that takes capital out, the nation's laws support mispricing that brings capital in.

Finally, it is argued that flight capital turns around and goes back from whence it came when investment conditions become favorable. While it is true that legally transferred flight capital often returns, the illegal component seldom does. That Venezuelan mentioned earlier is unlikely to bring his \$100,000 back, because he would not want to admit that he generated that money illegally in the first place. Private bankers know that flight capital, once out, rarely returns. The greater part, by far, of this wealth, motivated by its hidden accumulation, constitutes a permanent outward transfer.

## **Ends and Means**

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Isaiah Berlin, in his 1958 lecture at Oxford, "Two Concepts of Liberty," said, "Where ends are agreed, the only questions left are those of means, and these ... are technical, that is to say, capable of being settled by experts or machines like arguments between engineers and doctors."<sup>11</sup> Of course, Berlin was a philosopher, not a lawyer or politician or Wall Street banker.

According to a high-ranking U.S. Treasury Department official, the pursuit of tax-evading flight capital out of other countries has been supported as a matter of U.S. policy. Another Treasury official advised an executive vice president of a West Coast bank that his institution should open a

branch in the Caribbean to capture its fair share of flight capital.

U.S. bank regulators point out that a perception of foreign tax evasion is supposed to generate a suspicious-transactions report from financial institutions. Yet, banks in major money centers handle thousands of foreign trade documents and make deposits within their banks from those transactions to accounts belonging to the foreign trading partners, fully aware that tax evasion is the purpose.

An ex-Scotland Yard detective and expert on money laundering suggested to me in London that commercial banks cooperating with anti-money-laundering procedures know that such efforts cannot work. Just as I felt certain this viewpoint was excessively cynical, two Swiss bank compliance officers showed me their two-page policy declarations demonstrating how aggressively their institutions fight illegal flight capital. Knowing something about business and banking, I read and criticized their elaborate statements, obtaining a confirmation from each that the only thing meant by these legal obfuscations was that bank officers themselves should not physically transport cash, gold, or negotiable instruments from one country to another on behalf of their clients.

Sen. John Kerry, in his wake-up call about international crime, *The New War*,<sup>12</sup> says that the nations of the world "must agree both on a consistent system of laws and a consistent system of punishment" regarding illicit financial dealings. But the attainment of that goal is far off, requiring decades to reach consensus. An open letter to Congress published in major U.S. newspapers in February 1998, signed by 139 former presidents, secretaries of state, cabinet officers, national security advisors, senators, and current corporate CEOs, called on Congress to "insist on greater financial transparency"<sup>13</sup> in the global system. Given an appropriate level of will, the initial steps that can be taken are straightforward.

First, Western governments need to get much more aggressive in exposing corruption by foreign government officials and in seizing assets of such officials in or out of office. The United States froze the assets of Raoul Cédrès and his clique and thereby contributed to their departure from Haiti. Some of the assets belonging to Ferdinand and Imelda Marcos in the United States and Switzerland have been identified, though not yet returned to the government of the Philippines. The rationale for letting Mobutu keep his stolen billions was that he was a Cold War ally, a premise that has now lost

**T**ax-evading flight capital out of other countries has been supported as a matter of U.S. policy.

relevance. Western democracies should have a higher level of intolerance for serving as repositories of ill-gotten gains. Tools for seizing or freezing assets of corrupt leaders are available but underutilized.

Second, multinational corporations should be urged by commerce and treasury departments of Western countries to discontinue over- and under-invoicing to facilitate flight capital for foreign private interests. This practice is the dirty underside of international trade and should not be part of the negotiating tools of respectable companies. But no one has said this purposefully to major corporations, and, since it is legal, it is commonly done.

Third, the World Bank and the IMF need to address seriously the issue of illegal flight capital. Unfortunately, at the highest levels there is a close relationship between development bankers who hand money out to needy nations and private bankers who take at least twice as much back from these same nations, while at the middle levels there is a revolving door from the World Bank and IMF to leading commercial and investment banks worldwide. The result is that illegal flight capital, a sensitive issue, is not discussed in polite circles, and the goals of the World Bank and IMF are undermined in the process.

Fourth, nations that want to curtail the most common means of generating illegal flight capital, which occurs through the falsification of trade prices, can do so simply with two signatures, the buyer's and the seller's, on a routine trade document that says that the stated price is the actual price, without any element of mispricing for the purpose of creating value or benefit for a citizen of that nation in his country or in a foreign jurisdiction. Such a document, in the appropriate legal language of the country, can be backed by inspection and price-verification services in adopting nations, already common practice, buttressed with penalties for violations. Responsible buyers and sellers would not sign such a document and then risk paying kickbacks as usual, particularly in face of the possibility of fines or sanctions. With two signatures, the most prevalent component of illegal flight capital can be significantly curtailed.

Fifth, a Swiss banker cut to the core of the problem with what he would like to see adopted as standard procedure by his very prominent bank and other U.S. and European institutions: "one signature." Specifically, depositors should be required to sign a document stating that the deposit being made by any noncitizen, whether an individual or a company, is money legally earned and legally transferred. As he said, we do not have to get in the business of enforcing or abiding by other countries' laws, but we can tell our customers that we expect and require them to do so. Building on that, the international system can move toward the cooperation and consistency called for by Senator Kerry and others.

The combination of criminal money laundering and illegal flight capital constitutes the biggest loophole in the free-market system. Drug kingpins and global thugs thrive because money laundering is easy, and money laundering is easy because illegal flight capital is pursued and facilitated. Neither the United States nor any other nation will effectively curtail the one while at the same time soliciting the other.

Encouraging and facilitating the flow of tax-evading money out of developing and transitional economies contradicts the reason d'être for foreign aid and belies the purposes of the international financial institutions. Moreover, it contributes to widening income disparities between rich and poor and diminishes the lives of billions of people.

The breakthrough that is required is a clear reversal of current positions. Instead of supporting the movement of illicit funds between countries, we should do just the opposite—make it clear that this relic of an earlier, fragmented world is no longer acceptable.

Isaiah Berlin was, in a narrow sense, right; "where ends are agreed," the rest is technical.

## Notes

1. With a grant for research and writing from The John D. and Catherine T. MacArthur Foundation, not-for-attribution interviews were conducted in Venezuela, Brazil, Argentina, Nigeria, South Africa, Kenya, Egypt, Germany, Switzerland, France, England, Poland, Russia, Turkey, Saudi Arabia, Pakistan, India, Indonesia, China, South Korea, Japan, and the United States.
2. United Nations (UN) Office for Drug Control and Crime Prevention, *Financial Havens, Baking Secrecy and Money-Laundering*, (New York: UN, 1998), pp. 34-35.
3. *Amendment to The Federal Deposit Insurance Act*, U.S. Public Law 508, 91st Congress, October 26, 1970, H.R. 15703. Commonly referred to as the "Bank Secrecy Act," it was further amended in 1972 to raise the cash transaction triggering level to \$10,000.
4. United Nations Office for Drug Control and Crime Prevention, *Attacking the Profits of Crime: Drugs, Money and Laundering*, (Vienna: United Nations, 1998), p. 40.
5. "That Infernal Washing Machine," *The Economist*, July 26, 1997, p. 20.
6. *Foreign Corrupt Practices Act of 1977*, U.S. Public Law 213, 95th Congress, December 19, 1977, S. 305.
7. United Nations International Drug Control Programme, *World Drug Report*, (New York: Oxford, 1997), p. 124.
8. A different technique can be used to examine an alternative mispricing procedure—re invoicing. Many companies maintain offshore offices that change prices by interjecting new documents into transactions, ostensibly while performing a buying or selling service for their parent companies. Similarly, many banks and other financial institutions perform this service for customers, operating from locales in the Caribbean and the Channel Islands. This re invoicing activity can sometimes be isolated statistically for a class of products as a difference in export figures from one

country and import figures into another country. Re invoicing is much less commonly utilized than the simpler procedure of increasing or decreasing prices as a matter of agreement between buyers and sellers. Recent statistical surveys do, however, indicate that imports into Latin America are being routinely underpriced to escape VAT.

9. Central Intelligence Agency (CIA), "Table 76, Russia: Economic Support From the International Community, by Donor and Year 1989-98" *Handbook of International Economic Statistics, 1998* (Washington: CIA), p. 72.
10. Support for this observation comes from data provided by the Bank for International Settlements in Basle, Switzerland, on *Cross Border Bank Deposits of Nonbanks by Residence of Depositor*, broken down by countries of origin and principal countries of receipt.
11. Isaiah Berlin, *Two Concepts of Liberty* (London: Oxford, 1958), p. 3.
12. John Kerry, *The New War* (New York: Simon & Schuster, 1997), p. 187.
13. "A Time for American Leadership on Key Global Issues," *New York Times*, February 11, 1998, p. A18.